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CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Leslye Corsiglia

SUBJECT: **AFFORDABLE HOUSING FINANCE RISK ASSESMENT**

DATE: 01-04-05

Approved [signature] Date 1.5.05

INFORMATION

On September 29, 2004, Councilmember Reed submitted to the Rules Committee a request for consideration of a discussion and action on the risks that the City takes when it provides funding for affordable housing projects. This Information Memorandum responds to the issues raised by Councilmember Reed. In addition, this Memorandum provides a description of the major factors in the financial risk associated with affordable housing developments: (1) the timeframe for implementing an affordable housing transaction and (2) how the City's gap loans are sized.

TIMEFRAME FOR AFFORDABLE HOUSING TRANSACTIONS

The process of implementing an affordable housing transaction commonly takes several years – from the time a site is identified until the project has completed lease up. The process becomes especially protracted if there is need for zoning changes, neighborhood meetings and public hearings. The major stages in this process include:

- *Site acquisition* – Initially, the Housing Department may be approached by a developer that has obtained site control of a property or that is seeking City assistance in site assembly. The developer will typically have established a general development concept at this point – e.g., approximate number of units, unit mix and target affordability. In order to advance the project, the Housing Department may determine that a predevelopment loan or an acquisition loan is required.

- *Selection of the development team* – Historically, a developer that proposed a project would be evaluated by Housing Department loan staff to ensure that the development team, and the proposed project, conformed to the City's minimum underwriting criteria. In February 2003, the City Council approved a new project funding process that requires developers to respond to a Notice of Funding Availability ("NOFA") which established a competitive system for project selection and which rates developers and projects based on pre-established selection criteria. Developers still must meet minimum underwriting criteria, but may not be selected for funding if other projects are rated more highly in the competitive process.

- *Development of initial project budget and plan of finance* – During this phase, the City and developer will establish the approximate cost of the project, the estimated amount of funding available from non-City sources, the estimated funding gap and the approximate amount of the City loan.[1] The City and developer will determine the gap funding approach, which may include a loan for predevelopment costs (i.e., for entitlements, preliminary drawings, etc.), construction financing and/or permanent financing. Also during this phase, the City and developer determine whether the project characteristics would make it competitive for the limited pool of 9% tax credits or, alternatively, a better candidate for a tax-exempt bond allocation from the State.

- *Application to California Debt Limit Allocation Committee or the Tax Credit Allocation Committee* – For the City or any other public agency to issue bonds for an affordable housing project, it must receive a private activity bond allocation from the California Debt Limit Allocation Committee ("CDLAC"). The process entails the City filing an application with CDLAC, a review period and then the award of an allocation at a CDLAC meeting. As a precondition to filing with CDLAC, the project must be considered "ready" – with all discretionary approvals (i.e., zoning) in place. Significantly, CDLAC also requires that permanent financing commitments be in place, generally including a commitment from the locality that it will provide the necessary gap funding. The application process takes approximately two to three months from the time of submission to the actual award of allocation by CDLAC. However, the developer may need several months prior to filing an application to qualify the project as "ready."

  Similarly, a project that appears to meet the requirements for 9% tax credits must submit an application to the Tax Credit Allocation Committee ("TCAC"). Like CDLAC, TCAC requires that a project meet certain readiness tests and have permanent funding commitments in place. Because the TCAC 9% credits are substantially more competitive than the bond program, often doubling the amount of tax credit equity for which a project may be eligible, applicants may have to apply in two or three consecutive rounds before a project is funded.

- *Bond Issuance Process* – Following the award of an allocation, CDLAC will require bond issuance to occur within 90 – 110 days. Failure to issue the bonds by the CDLAC deadline results in forfeiture of the CDLAC allocation, loss of a financial deposit with CDLAC, the assessment of negative points to the developer for future CDLAC applications (jeopardizing eligibility for future funding) and the need to re-apply for a new allocation.

SIZING THE CITY'S LOAN

The City's gap loan is but one component of the sources of funding for affordable housing projects. The gap loan funds that portion of a project's costs that cannot be financed with the

[1] Municipal lenders are typically "gap" lenders on affordable housing projects. This means that they will fill the gap between reasonable development costs and the other sources of funding that may be available to build the project. Project sponsors may be required to contribute "deferred developer fees" as an equity contribution to fill funding gaps- deferred developer fees essentially represent deferred payment for managing the development financing and construction process. In some cases developers may be required to defer fees in excess of $2 million, as permitted by TCAC. Developers are typically required to defer developer's fees when a project experiences cost increases or other circumstances that develop after a project is originally presented to the City, thereby putting the developer's return at immediate risk.

other sources of external financing, namely the permanent loan, a construction loan and tax credit equity. As "gap lenders", public lenders essentially size loans by determining the estimated project costs and deducting the estimated amount that could be generated from non-City sources. Historically, based on expected development costs and the availability of other funding sources, the City's gap loan ranged from approximately $60,000 to $85,000 per unit, with the size varying with the depth of income-targeting, the levels of affordability and other variables. More recently, the City is targeting projects that require subsidies that are less than $60,000 per unit.[2]

The amount of funding available from non-City sources, in turn, is constrained by several factors not necessarily related to the project's costs.

- *Permanent Loan*: The size of a permanent loan is generally determined by project cash flow, interest rates, debt service coverage requirements and loan term. Affordable housing projects generate less cash flow than market projects, appraise at lower values and, thus, support relatively lower loan amounts relative to the costs of the project. This creates a significant gap between the size of the permanent loan and the project costs.

  The maximum size of a permanent loan is fixed relatively early in the process – before application to CDLAC. At the time the financial transaction closes (which may be six months after the CDLAC application is filed), increases in interest rates over the assumed rate and/or changes to rent estimates may cause a reduction in the permanent loan size. The permanent loan size may be further reduced after the project is completed and leased up, based on the rent levels actually realized at initial occupancy.

  Because the permanent loan is effectively capped by project proforma rents, unless project costs decline from the original budget, the tendency is for funding gaps to increase.[3]

- *Construction Loan*: The size of the non-City construction loan is limited to the aggregate amount of permanent financing sources including the permanent loan amount, permanent gap loan and/or tax credit equity. Thus, if the permanent loan amount is reduced due to lower project rents and/or higher interest rates, non-City construction loan funding may also diminish unless the gap can be filled through another source.

- *Tax Credit Equity*: The federal Low Income Housing Tax Credit Program (as well as a smaller State tax credit program) provides eligible investors in qualified low-income housing projects a reduction in income taxes based on the cost of building a project. The tax credit equity that investors will contribute to a project is based on the depreciable costs of the

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[2] In the past, the City's gap loan could represent 20% to 60% of total project costs. Under the new NOFA process, projects will receive points only if the City's subsidy ranges between 21% and 26% of total projects cost. Projects that fail to achieve that level of leveraging receive no points and are not likely to reach the minimum score for funding.

[3] Several years ago, many lenders were willing to size permanent loans on the basis of future rents that were projected to be in effect at the time that the project is ready for leasing. This approach resulted in higher loans. Currently, lenders will size their loans on the basis of rents in the current market for similar unit types. In fact, given the recent declines in rent levels in San Jose, lenders may actually discount current rents, further reducing the permanent loan amount.

project, the timing of equity payments (later pay-ins result in more equity dollars) and the overall market for tax credits. An increase in project costs will generate more tax credits, but not on a dollar-for-dollar basis. The additional tax credit equity stemming from higher costs by no means will close a funding gap.

Under the current NOFA process used by the City, the amount of the City's funding commitment for a project is set prior to the selection of a developer and project and is based on the proposed budget submitted by the developer and the estimate of the gap for that project. The competitive NOFA criteria create pressure on developers to keep the City's subsidy amount low or run the risk of failing to receive funding. The City's NOFA has clarified to developers that, due to the competitive ranking of the NOFA process, the City will not approve requests for funding that exceed the amounts indicated in their approved applications.

GAP LOAN RISK EXPOSURE

General – Need to Subordinate City Loans. The non-City lenders in affordable housing projects require the City to subordinate the affordability restrictions as well as the lien and the repayment of its gap loans. The City receives repayment after the other lenders are paid and has limited rights to institute remedies upon default.

As a gap lender, the City, by definition, assumes greater risk than the senior lenders. The nature of those risks, as well as potential mitigating steps the City can take, will depend upon the stage of a type of funding that the City provides.

Acquisition and Predevelopment Gap Loans – These loans are made to assist developers in funding all or a portion of the costs of acquiring the land to be developed and the costs of the entitlement process. During the course of the project's life cycle, the City's acquisition and predevelopment loan will typically be rolled into a construction loan for the project and, upon completion, will be rolled into a permanent loan.

These gap loans typically represent the first component of the overall plan of finance for a project and are made well before development costs are finalized or the other lending commitments are made. In making such a loan, the City bears the risk that other elements of the project do not come together. Since this kind of loan is made so early in the process, there is more time for circumstances to develop that could cause a project to stall (e.g., increased costs, lack of CDLAC allocation, increased interest rates, changing rental market, etc.).

Acquisition and predevelopment loans are arguably the riskiest form of gap financing. However, the City also has an effective remedy not generally present with construction and permanent loans. If the developer is unable to start construction, the City can foreclose on the real estate as there are usually no other lenders involved in this phase of the project funding.

Under the new NOFA system adopted by the City Council, the City is no longer providing land acquisition loans to affordable housing developers. Rather, the City will only disburse funds once the developer has secured all other permanent funding commitments and is ready to proceed with construction. This new policy requires developers to assume a greater risk by funding land options and predevelopment expenses, as well as negotiating longer land option agreements that ensure adequate time to package the necessary permanent funding commitments. This change has substantially shifted the risk of the City's affordable housing loans.

Construction Gap Loans – These loans become effective just prior to commencement of construction. The City begins disbursing funds after the project budget is finalized. Upon project completion, the City's construction loan rolls into a permanent loan.

The senior construction lender requires all subordinated construction loans and tax credit equity dollars to be expended prior to disbursing its loan. Therefore, the City's construction gap loan typically represents the first funds disbursed during construction. If the developer does not complete construction, but the senior construction lender has not yet disbursed its funds, the senior construction lender will usually not have the prior right to foreclose on the property. The senior lender, however, may still retain the right to control the type of remedy exercised by the City.

At the start of construction, the project budget is theoretically in balance – the aggregate sources of funding will equal the projected costs of construction, plus a contingency. As the junior construction lender, the City assumes the first level of risk that the construction budget falls out of balance (i.e. that the costs exceed the sources of funding).

The City's risk is exacerbated by the fact that the size of its construction loan is typically established several months before construction begins or the budget becomes finalized, a result of the lengthy time (about six months) for the CDLAC application and bond issuance process. This time lag exposes the City both to the risks that construction costs will increase prior to finalizing the budget and/or the senior construction lender cannot lend the full amount of its initial estimated loan[4].

Under the Municipal Code, the Director of the Housing Department is authorized under certain conditions to increase the size of the City's gap funding up to 20% of the loan amount approved by the City Council. In exchange, the developer provides some consideration for the additional loan, such as increased affordability of the residential units. Beyond that point, City Council approval would be required for any increase in the size of the City's loan. The City loan is ultimately payable from project cash flow-- increasing the size of the gap loan will not likely lead to the potential for an increased return.

The City's risk with respect to construction loans changes during the construction process. For example, the City's financial exposure increases as it disburses its gap construction loan but prior to the use of permanent lending sources. During this period, however, the City continues to have meaningful remedies similar to those available during the acquisition/predevelopment loan phase. The City may foreclose on the partially constructed project and seek a replacement developer to complete the job (though, of course, such remedies come with their own costs and risks that vary from project to project.) As the senior construction loan is disbursed, the developer is effectively "going hard" on its commitment to complete the project, a commitment typically secured by personal guaranties. The developer's risks may grow during this period of

[4] As noted previously, the construction lender will want assurances that the take-out financing is in place. The amount of the take-out financing could decline from the time of the CDLAC application if interest rates increase above the rate assumed for loan sizing or the projections for project rents decline.

time, as personal guarantees may be called on in the case of increased costs or funding sources that do not materialize. However, concurrently, the City's remedies become less effective, as a decision by a senior lender to foreclose may wipe out the City loan, its liens and the affordability restriction.

Permanent Gap Loans – Once project completion occurs, the City's construction loan will convert to a permanent gap loan. The City's permanent loan is typically in the form of a residual receipts loan. It is non-defaulting as to payment (i.e., "soft debt"), with the City receiving excess project cash flow after all operating expenses are paid, reserves funded, senior debt service obligations satisfied and certain other senior lender and tax credit equity cash flow requirements are met.

The City negotiates the split of residual cash flow after payment of these other obligations. The City typically has sought between 50% and 75% of the residual cash flow, with the balance staying with the developer. Some lenders, such as Fannie Mae and Freddie Mac, will require the borrower to retain at least 50% of the residual cash flow to create an incentive for the developer to manage the project as efficiently as possible. The Housing Department's NOFA has established that residual receipts will be divided equally between the developer and the City (i.e., 50%/50%).

In the event of non-payment of the City permanent gap loan, the City's remedies are rather limited because the City subordinates most of its remedies and liens to the senior lender's liens and remedies.

RISK MITIGATION

In general, the City's risk mitigation measures depend on the type of loan:

Acquisition/Predevelopment Loans – As noted previously, these loans are arguably the riskiest undertaken by the City. Because a senior lender is not typically involved at this stage, the City is usually in a position to exercise meaningful remedies in the event the project stalls. Nonetheless, as indicated above, the City has indicated to developers that the City will no longer provide acquisition/predevelopment loans.

Construction Loans – During the construction phase, the City's tries to ensure developer performance through the following means:

- **Withhold Payment of Developer Fee Until Completion** – This represents the City's biggest lever over the developer. The developer will not receive payment of its developer fee until it meets certain benchmarks during the construction process. The developer fee is capped by California Tax Credit Allocation Committee (CTCAC) limitations and may range from $500,000 to $2,400,000, depending on project size and whether it is a new construction project. For-profit developers generally will insist on the higher fee, while nonprofit developers will often take lower fees to ensure the project's affordability. While the smaller fee results in an overall reduced project budget, the larger fee creates the greater incentive to perform.

- **Prior Negotiation of Project Budget Elements** – The City, the developer and senior lender will scrutinize each line item of the project budget prior to closing a bond issue. The City typically retains an outside value-engineering consultant to review and confirm costs. The City will not approve cost items that do not fall within an acceptable range based on the City's prior experience.

- **Review of Developer Financial Capacity and Experience** – The City seeks developers with proven track records and the financial capacity to take a project through completion. The City requires that a developer have successfully completed at least three prior affordable projects or, in the absence of adequate prior experience, partner with experienced developers and affordable housing consultants.

- **Maximize Permanent Loan Amount and Tax Equity Investment** – To the extent a developer can increase its permanent loan and tax credit equity, the non-City portion of the construction loan will also increase. In turn, the gap to be funded by the City will decrease. While the City does not dictate the financing structure that a developer should use, it carefully reviews the assumptions underlying permanent loan sizing and tax credit equity estimates for reasonableness. For example, if the tax credit equity assumptions are too low, the City may require the developer to look to another investor or bid out the equity. In addition, excessive operating expenses will reduce the amount of debt that the project will carry and, accordingly, are scrutinized by the City's underwriting staff.

- **NOFA Process** – By specifically limiting the amount of City funding available for a project, the NOFA process should strengthen the City's hand in working with developers. The responsibility, and risk, should fall squarely on the developers to ensure the project's feasibility.

Permanent Loan – As noted previously, payment of the City's permanent loan derives from project cash flow. The Housing Department seeks approximately 50% of the residual cash flow. The project's ability to generate residual cash flow will depend on market conditions and affordability restrictions, with the deeper affordability requirements generally leading to a more limited ability to raise rents and a more limited residual cash flow.

If a project does not generate residual cash flow as projected, Housing Department staff will review the project performance with the developer. The City will evaluate the overall market conditions, whether the project is being operated and managed consistent with industry practices and the financial assumptions used when the project was initially underwritten. The City will consider several possible remedies, including replacement of the property management company, increased contributions by the limited partners, refinancing of any outstanding debt or restructuring of the City's loan. Such steps generally require the consent of the senior lender and tax credit equity investor.

CONCLUSION

As the gap lender, the City faces a certain tension between increasing the affordable housing stock in San Jose and receiving a return on its investment. The City's increased focus on deeper affordability coupled with the persistent high costs of land and construction and the potential for higher interest rates will cause that tension to heighten. The newly instituted NOFA process will add more certainty to the amount that the City will contribute to a project and to developer expectations of City funding capabilities. However, the City's basic risk position will remain mostly unchanged as other lenders will always expect the City to subordinate it liens, repayment obligations and its remedies to their loans.

COORDINATION

This memorandum has been coordinated with the Department of Finance and the Office of the City Attorney.

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